# DEBT CONSERVATISM AND DEBT-EQUITY CHOICES: EVIDENCE FROM REITS' UNUSED DEBT CAPACITY

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## ABSTRACT

**Purpose -** In this paper, we complement the literature on underleveraged phenomenon by examining how firms adjust towards or away from their debt capacity when issuing or repurchasing securities. Controlling for factors known to affect firms' debt-equity choice, findings of equity issues by firms with high unused debt capacity will support debt conservatism behavior because these new issues tend to push firms away from their debt capacity that make them more underleveraged. Focusing on unused debt capacity also allow us to contrast our hypotheses with extant capital structure theories that carry the opposite predictions with respect to the relationship between unused debt capital and debt-equity choice. These theories predict a positive (negative) relationship between debt (equity) issue and unused debt capacity. In other words, firms tend to issue securities that make them converge closer to their debt capacity or optimal debt ratio.

**Methodology -** Following Hovakimian et al. (2001) and de Jong et al. (2011), we estimate a binary logit model with marginal financing decisions (*Marginal*) as a function of unused debt capacity. We use quarterly changes in balance sheet information to identify debt and equity issues/ repurchases. Equity issues (repurchases) are defined as increase (decrease) in total capital stock (exclude retained earnings) while debt issues (repurchases) correspond to increase (decrease) in total debt. The following filters were applied so that only material events are included in the sample of financing activities: The sum involved must, firstly, be larger than US $5million and the amount must also constitute more than 1% of the REIT's total assets. Cases where REITs issued (repurchased) both debt and equity issues are omitted.

The estimated logistic model is as follows:

$$Marginal_{it} = \alpha_1 + \alpha_2 Debt\ buffer_{it-1} + \theta \mathbf{X}_{it-1} + \phi \mathbf{M}_{it} + \mathbf{P}_i + \mathbf{Y}_t + u_{it} \quad (1)$$

where $\mathbf{X}_{it-1}$ and $\mathbf{M}_{it-1}$ $\mathbf{P}_t$ $\mathbf{Y}_t$ are the vectors of firm characteristics, market timing variables, property and year dummies respectively and $u_{it}$ is the residual assumed to be serially uncorrelated with mean zero. The vector X contains the controls for traditional capital structure determinants such as cash holding, size, age, growth opportunities, profitability and asset tangibility. Vector M on

the other hand controls for market timing behavior including past stock returns, interest rate and term structure. These variables capture financial managers' market timing behavior by taking advantage of the relative costs of debt and equity capital in raising capital.

**Findings -** We find support for debt conservatism behavior where high debt buffer REITs tend to issue equity that makes them further deviate from their debt capacity. This main result is robust to a battery of robustness check implying that debt conservatism is the first order priority in capital offering choices. We further show that this debt conservatism behavior persists for a period of at least 2 years and is driven by firms operating below their optimal debt ratio. We do observe debt convergence in repurchasing decisions. The adjustment pattern is asymmetric where high buffer REITs adjust at a slower pace towards their debt capacity compared to low buffer REITs. This debt conservatism behavior is not influenced by proxies to corporate liquidity/financial constraints and could not be explained by trade-off and pecking order theories.

**Keywords:** Debt conservatism, unused debt capacity, REITs, capital structure, Malaysia.

## CONCLUSIONS

This paper shows that conservatism behavior is a first-order consideration in firms' debt-equity choices. Our approach differs from most previous papers as it focuses on REITs' debt adjustment process towards/away from its debt capacity subject to individual REITs' debt buffer. We find that compared to low buffer REITs, high buffer REITs tend to issue more equity that render them to deviate further from debt capacity and move much slower towards their debt capacity through equity repurchases.

## REFERENCES

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